

TESTIMONY
OF
THOMAS MOERS MAYER

February 26, 2015

Hearing of the House of Representatives' Committee on the Judiciary's Subcommittee on
Regulatory Reform, Commercial and Antitrust Law

on

H.R. 870: "Puerto Rico Chapter 9 Uniformity Act of 2015"

Thomas Moers Mayer
Partner and Co-Chair,
Corporate Restructuring and
Bankruptcy Group
Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, NY 10036
212-715-9169
tmayer@kramerlevin.com

Chairman Marino, Ranking Member Johnson, members of the Sub-Committee – thank you for inviting me to testify on H.R. 870.

My name is Thomas Moers Mayer.¹ I represent certain funds managed by Franklin Municipal Bond Group (“Franklin”) and by OppenheimerFunds, Inc. (“Oppenheimer”) in connection with their investment in approximately \$1.6 billion of bonds issued by the Puerto Rico Electric Power Authority, or “PREPA”. Franklin and Oppenheimer have been for many years two of the largest investors in bonds issued by Puerto Rico and its governmental corporations.

We oppose H.R. 870 and the application of Chapter 9 in its current form to Puerto Rico. Use of Chapter 9 by any of Puerto Rico’s public corporations will cause more harm than good, for both millions of Americans who invested in Puerto Rico bonds and for the Commonwealth.

About 9.5 million U.S. taxpayers invest in municipal bonds, either directly or through funds like Franklin and Oppenheimer.² Franklin alone has approximately 200,000 investors in the funds that own bonds issued by Puerto Rico and its government corporations.³

Puerto Rico is the third largest issuer of municipal bonds in the United States. Its bonds are tax exempt in every state of the union and Puerto Rico’s instrumentalities borrow to fund almost all the capital needs of the island. Why are they tax exempt in every state? Because

¹ I am a partner and co-chair of the Corporate Restructuring and Bankruptcy Group at Kramer Levin Naftalis & Frankel, LLP. See Exhibit A. I am also a member of the National Bankruptcy Conference (“NBC”), which last year provided its own statement in support of a predecessor to H.R. 870. I was not a signatory to the NBC’s statement and abstained from a vote on it. My testimony today is not on behalf of the NBC, which has not reviewed it.

² In 2012, 5,954,819 tax returns reported tax exempt income, comprised of 3,532,100 tax returns from married couples filing jointly, or 7,064,200 individuals, and 2,422,719 other individual tax returns, for a total of 9,486,919 individuals. *Statistics of Income, 2012 Individual Income Tax Returns, Publ. 1304*, U.S. Dep’t of the Treasury, Internal Revenue Service, Table 1.3 at 36 (2012), http://www.irs.gov/file_source/pub/irs-soi/12inalcr.pdf [hereinafter “*IRS Publ. 1304*”].

³ Oppenheimer has over 400,000 individual investors in all its municipal funds.

Congress made them so. Congress passed legislation granting Puerto Rico this special advantage, to make it easier and less costly to borrow money from men and women in jurisdictions outside Puerto Rico.⁴

Men and women throughout the country own PREPA bonds in their own name or through funds. The funds I represent include funds for taxpayers in California, Georgia, New York, Pennsylvania and Virginia – and all these funds hold PREPA bonds. It is probable that more citizens invest in Puerto Rico bonds than live in Puerto Rico.

These bondholders are individual savers. Most tax returns showing tax-exempt income are filed by taxpayers over 65⁵ and most report incomes under \$100,000.⁶ These people live on Main Street, not Wall Street.⁷

This bill would affect \$48 billion of Puerto Rico's municipal bonds⁸ owned by millions of investors nationwide – including in Puerto Rico itself.

Puerto Rico enacted its own debt restructuring law, which unfairly sought to strip value from bondholders.⁹ That law was terrible. It was much worse than Chapter 9. The U.S. District Court in Puerto Rico struck down that law as unconstitutional.¹⁰

But Chapter 9 is not much of an improvement. Chapter 9 hurts bondholders. Exhibit B contains a chart showing how badly Chapter 9 hurt bondholders in Detroit, Michigan; Stockton and Vallejo, California; and Jefferson County, Alabama. Chapter 9 is not a good thing for the

⁴ 48 U.S.C. § 745.

⁵ IRS Publ. 1304, *supra* note 2, Table 1.5 at 73.

⁶ *Id.* Table 1.4 at 40.

⁷ The “household sector” held almost 43% of all municipal bonds as of September 30, 2014. *Federal Reserve Statistical Release Z.1, Financial Accounts of the United States*, Bd. of Governors of the Fed. Reserve Sys. 101 (Dec. 11, 2014), available at <http://www.federalreserve.gov/releases/z1/current/z1.pdf>. Mutual funds together held an additional 25.4%. *Id.*

⁸ Financial Information and Operating Data Report, Commonwealth of P.R., 88 (Oct. 30, 2014) <http://www.gdbpr.com/documents/CommonwealthReport-October302014.pdf>.

⁹ Puerto Rico Public Corporation Debt Enforcement and Recovery Act, Law 71-2014 (June 28, 2014).

¹⁰ *Franklin California Tax-Free Trust et al. v. Puerto Rico*, 2015 WL 522183 (D.P.R. Feb. 6, 2015).

municipal bond market,¹¹ which is why 23 states have not authorized their municipalities to file a Chapter 9 petition and why Georgia and Iowa have affirmatively prohibited municipalities from filing for Chapter 9.¹²

Puerto Rico's water and sewer agency needs to sell hundreds of millions of bonds in the near future. If Congress extends Chapter 9 to Puerto Rico, we predict that the agency will not be able sell any bonds unless it is prohibited from seeking Chapter 9 relief or the bonds are guaranteed by the Commonwealth and bear an extortionate interest rate with onerous security features.¹³ That will be true for every Puerto Rico governmental corporation for the foreseeable future.

PREPA itself does not need Chapter 9. It can fix itself. It can raise revenues in the same manner as nearly every other municipally owned utility in the United States. PREPA has not raised its "base rate" – the rate that pays for everything other than fuel and purchased power – in nearly 26 years. Every other public utility in the country sets its rates at a level sufficient to service its bonds and cover its other costs.

¹¹ Fitch Ratings issued a release on August 6, 2014 titled "Chapter 9 Extension Would be a Positive for Puerto Rico", but a careful reading shows that Fitch wanted Chapter 9 to apply to PREPA and the sewer company because Fitch thought it would be good for other Puerto Rico bonds – the sales tax bonds – which, in Fitch's view, would not be subject to Chapter 9. *Chapter 9 Extension Would Be a Positive for Puerto Rico*, Fitch Ratings, Inc. (Aug. 6, 2014), available at https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?print=1&pr_id=845614. Fitch thus reflects a political reality: the only bondholders who back Chapter 9 are those who believe it will never apply to them, including, in particular, certain holders of general obligation bonds issued by the Commonwealth itself.

¹² The State Role in Local Government Financial Distress, The Pew Charitable Trust, 9-12 (July 2013), available at http://www.pewtrusts.org/~media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf.

¹³ There are conflicting studies on the effect of Detroit's Chapter 9 filing on the municipal bond market. The Federal Reserve of Chicago purported to show that interest rates on bonds issued in Chapter 9-eligible states did not increase compared to Chapter 9-ineligible states. Gene Amromin & Ben Chabot, *Chicago Fed Letter No. 316: Detroit's Bankruptcy: The Uncharted Waters of Chapter 9*, THE FED. RESERVE BANK OF CHI. (Nov. 2013), available at <https://www.chicagofed.org/~media/publications/chicago-fed-letter/2013/cflnovember2013-316-pdf>. However, the study does not take into account the dramatic widening of interest rates spreads for Chicago's bonds following Detroit (see Exhibit C).

PREPA could raise its base rate tomorrow, and consumers would still pay less than they did six months ago, because fuel costs are down.

PREPA's own consultants have identified numerous readily obtainable operational improvements and potential efficiency savings that, if implemented, would diminish the base rate increase, providing consumers with further savings.¹⁴

PREPA could collect what it is owed. The Commonwealth and its various governmental corporations owe PREPA more than \$828 million.¹⁵ The governments have been in arrears for years. Puerto Rico's municipalities pay PREPA almost nothing for their power.¹⁶ Puerto Rico wants to use Chapter 9 so its local governments do not have to pay their electric bills.

In sum, Puerto Rico wants to use Chapter 9 to save a few cents per kilowatt hour,¹⁷ to let citizens in Puerto Rico pay less for power than citizens in Hawaii¹⁸ or New York City,¹⁹ by forcing bondholders in the 50 states to shoulder the burden of PREPA's operational failures and Puerto Rico's fiscal irresponsibility.

The contention that only Chapter 9 provides "certainty" is not true.

¹⁴ Many of these initiatives can be found in the Accounts Receivable and CILT Report prepared by FTI Capital Advisors, LLC. *Accounts Receivable and CILT Report*, FTI Capital Advisors, LLC, 9 (Nov. 15, 2014), <http://www.aepr.com/Docs/restrukturacion/PREPA%20AR%20and%20CILT%20Report%20Final.pdf> [hereinafter "AR and CILT Report"]. The AR and CILT Report is also on file with the Committee.

¹⁵ *Monthly Report to the Governing Board*, P.R. Elec. Power Auth. (Dec. 31, 2014), available at <http://www.aepr.com/INVESTORS/DOCS/Financial%20Information/Monthly%20Reports/2014/December%202014.pdf>. This is an increase from the \$750 million reported by the Commonwealth's own advisor, see AR and CILT Report, *supra* note 14, at 9.

¹⁶ In theory, PREPA rebates to Puerto Rican municipalities the cost of their power as a "contribution in lieu of taxes." In fact, no money appears to change hands, and the credit each municipality receives is not related to any calculation of any "taxes." Because municipalities pay almost nothing for power, they waste electricity and enter into agreements that allow private parties to benefit from the municipalities' free power.

¹⁷ PREPA currently charges approximately 23 cents a kilowatt hour (including fuel surcharges). Debt service on PREPA's bonds comprises about 3-1/2 cents of the total.

¹⁸ *Rankings: Average Retail Price of Electricity to Residential Sector*, U.S. Energy Info. Admin. (Nov. 2014), <http://www.eia.gov/state/rankings/#/series/31>.

¹⁹ Con Edison in New York charges more than 24 cents per kilowatt hour. See *Retail Sales 2013 with Average Res Rates, Electric Power Sales, Revenue, and Energy Efficiency Form EIA-861*, U.S. Energy Info. Admin. (2013), available at <http://www.eia.gov/electricity/data/eia861/zip/f8612013.zip>; see also Bill Sanderson, *Con Ed Seeks To Increase City Residential Electric Rates*, N.Y. Post, Feb. 1, 2015, <http://nypost.com/2015/02/01/con-edison-seeks-to-increase-city-residential-electric-rates>.

First, Chapter 9 itself does not offer “certainty”. Chapter 9 is the Wild West. It is not like Chapter 11. There is no established body of case law and there have been very few cases. The only certainty is that Chapter 9 takes a long time – at least 18 months to three years – and is very expensive. Detroit’s Bankruptcy Judge just days ago approved \$178 million in fees as “reasonable.”²⁰

Second, Puerto Rican law already provides an alternative: receivership. A court in Puerto Rico will pick the receiver. A court in Puerto Rico will control the receiver. The receiver will keep the lights on – but the receiver can also collect from the government and raise rates.²¹

I’ve heard the question, “why shouldn’t Congress give Puerto Rico the same access to Chapter 9 as a state?”

After Congress passed a law denying Puerto Rico access to Chapter 9,²² millions of individuals nationwide invested billions of dollars in reliance on that law. H.R. 870 breaks faith with those millions of men and women.

And there are good reasons why states have access to Chapter 9 and Puerto Rico does not. Congress chose to give Puerto Rico bonds a nationwide tax exemption, enjoyed by no state – and Congress chose to exclude Puerto Rico from Chapter 9. The benefit and the restriction go together.²³

²⁰ *In re City of Detroit*, No. 13-53846, 2015 WL 603888, at *27 (Bankr. E.D. Mich., Feb. 12, 2015).

²¹ Bondholders do not need Chapter 9 to protect themselves. Bondholders have rights under their trust agreements and Puerto Rico law, which they relied upon in their investments. Bondholders cannot rely on Chapter 9 to provide any “certainty.” Exhibit B and n.26 *infra*. Only holders of bonds not affected by Chapter 9, such as general obligation bonds of the Commonwealth, could make such an argument.

²² P.L. 98-353, § 421, 98 Stat. 333 (July 10, 1984) (codified at 11 U.S.C. § 101(52)).

²³ Generally, a state’s municipal bonds are exempt from state and local tax only in that state. Therefore tax-exempt bonds issued by California municipalities are held primarily by California tax payers, Pennsylvania tax-exempt bonds primarily by Pennsylvania tax payers, etc. When a state authorizes its municipalities to file under Chapter 9, that authorization will affect primarily taxpayers in that state. But Puerto Rico’s bonds are tax exempt everywhere and therefore held primarily outside of Puerto Rico. If Congress enacts H.R. 870, Puerto Rico’s decision to authorize PREPA (or any other municipality) to file under Chapter 9 will affect primarily individual investors outside of Puerto Rico.

Finally, Puerto Rico is not a state – by Puerto Rico’s own choice. Puerto Rico’s citizens have repeatedly voted against statehood, in part because Puerto Rico enjoys benefits no state receives. Not only does Puerto Rico have a unique ability to sell tax exempt bonds nationwide, Puerto Ricans do not pay any federal income tax.²⁴

Franklin and Oppenheimer would not oppose the application of Chapter 9 to Puerto Rico if Congress made Chapter 9 a fairer statute, which would take only a few changes. For instance, Chapter 9 could require an affirmative bondholder vote before a plan affects the bondholders.²⁵ That’s what the Bankruptcy Act required before 1978.²⁶

²⁴ Puerto Ricans do not pay federal income tax on income derived from Puerto Rico. 26 U.S.C. § 933.

²⁵ Chapter 9 should also be amended to provide that only actual and current out-of-pocket expenses necessary to maintain operations (excluding, for example, the municipality’s attorneys’ fees) may be deducted from revenues pledged to bondholders, with the balance paid currently to bondholders. That is the clear intent of 11 U.S.C. §§ 902 & 928.

²⁶ Prior to 1978, no municipality could file for relief under the Bankruptcy Act unless the petition was accompanied by a plan accepted, in writing, by creditors owning not less than 51% of the securities affected by the plan. Section 83(a) of the Bankruptcy Act of 1898, *as amended by* The Municipal Bankruptcy Act of 1937, Pub. L. No. 302, 50 Stat. 652 (1937) (codified at 11 U.S.C. § 403(a) (1970)).

Chapter 9 currently provides for a bondholder vote, but the vote can be meaningless if the bonds are classified with plan-supporting claims, as was the case in *City of Stockton*. Stockton paid pennies to bond claims but forced them to vote in the same class as vastly larger and more numerous retiree medical claims. The retirees voted “yes” because [a] they could get substitute medical coverage from their current employer, from their spouse’s employer, or from the Affordable Care Act, and [b] while their retiree medical claims were receiving pennies, their pension claims were being paid in full. *In re City of Stockton, California*, No. 12-32118-C-9, 2015 WL 515602, at *21-22 (Bankr. E.D. Cal. Feb. 4, 2015).

Chapter 9 also provides that a plan can be confirmed over a dissenting bondholder vote so long as it does not “discriminate unfairly” against the bonds. The City of Detroit gave a group of bondholders their own class, but paid them 13 cents while paying pensioners 59-60 cents. *In re City of Detroit*, 524 B.R. 147, 253-54 (Bankr. E.D. Mich. 2014). Bankruptcy Judge Rhodes held this was not “unfair discrimination” because it did not offend “the judgment of conscience,” including “the Court’s experience and sense of morality” – a novel standard never before applied to “unfair discrimination” and for which the Court cited no precedent – and therefore the plan could be confirmed irrespective of a bondholder vote. *Id.* at 253, 256. Bondholders withdrew their objection to the plan and changed their vote only after Judge Rhodes made it perfectly clear he was going to rule against them.

The last remaining protection for dissenting bondholders is the requirement that a plan be in the “best interests of creditors.” 11 U.S.C. § 943(b)(7). According to the legislative history of this section, the “best interests” test requires the municipality to make a detailed showing that it has done what it can to pay creditors. 124 Cong. Rec. H11,100 (Sept. 28, 1978); S17,417 (Oct. 6, 1978). However, this requirement was, again, effectively disregarded in Detroit, where Judge Rhodes did not require the city to maximize payments to bondholders because he held that bondholders’ remedies outside of Chapter 9 would not yield a better result. *City of Detroit*, 524 B.R. at 213-17. PREPA’s secured bondholders, like Jefferson County’s secured sewer warrant holders, do have the remedy of a receiver, and Jefferson County’s warrant holders did contend that Section 943(b)(7) required Jefferson County to raise sewer rates. The issue settled before trial.

But without changes to Chapter 9, H.R. 870 only hurts millions of investors and, again, the Commonwealth itself. Puerto Rico, its public corporations and municipalities, must borrow billions of dollars, this year and in each year to come. H.R. 870 threatens to limit, if not eliminate, access to the low-cost financing provided by traditional long-term municipal bond buyers. H.R. 870 serves the interests of neither the Commonwealth nor the millions of individuals who invested in the bonds of the Commonwealth's corporations.

Exhibit A



Email

tmayer@kramerlevin.com

Phone

212.715.9169

Fax

212.715.8000

Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, NY 10036

Thomas Moers Mayer

Partner

Co-chair, Corporate Restructuring and Bankruptcy

Thomas Moers Mayer is co-chair of Kramer Levin's 45-attorney Corporate Restructuring and Bankruptcy Department.

Mr. Mayer has represented Official Committees of Unsecured Creditors in some of the largest cases in history, including General Motors, Chrysler, Capmark, Smurfit-Stone and Dana Corporation. Mr. Mayer has also played major roles in the largest municipal insolvencies, representing holders of \$900 million in secured sewer warrants of Jefferson County, Alabama in that County's chapter 9 case and \$1 billion in Certificates of Participation in the Detroit chapter 9. Mr. Mayer leads the Kramer Levin team focused on heavily indebted Puerto Rico and its instrumentalities. He currently assists Amy Caton in her representation of \$2.4 billion of secured bonds issued by the Puerto Rico Electric Power Authority.

Mr. Mayer has also represented investors in financially distressed companies. His transactions include the 1991 acquisition of Wheeling-Pittsburgh Steel Corporation and the 2006 hostile takeover of WCI Steel Corporation, both through chapter 11 plans supported by the United Steelworkers of America. He is the leading scholar on trading claims and taking control of corporations in chapter 11, having authored or co-authored (with Chaim J. Fortgang) five published articles and the *Collier Bankruptcy Manual* chapter on the topic.

Chief Justice John Roberts of the United States Supreme Court appointed Mr. Mayer to the United States Judicial Conference Advisory Committee on Bankruptcy Rules for a three-year term starting October 1, 2014.

Mr. Mayer is a member of the National Bankruptcy Conference, a non-partisan organization of approximately 60 leading lawyers, law professors and bankruptcy judges which provides bankruptcy advice to Congress. He is also a Fellow of the American College of Bankruptcy, an honorary association of approximately 800 leading senior insolvency professionals.

Honors and Distinctions

- Listed in *Benchmark Litigation*, 2015
- Included in *The Best Lawyers in America*, 2015
- Recognized in *Chambers Global*, 2014
- Included in *Legal 500 US*, 2014
- Included in *New York Super Lawyers*, 2014
- Adjunct Professor, Cardozo Law School (1998)

Thomas Moers Mayer

Continued

Professional Affiliations

- Member, Association of the Bar of the City of New York

Education

- J.D., *magna cum laude*, Harvard Law School, 1981
Editor, *Harvard Law Review*
- A.B., *summa cum laude*, Phi Beta Kappa, Dartmouth College, 1977

Bar Admission

- New York, 1982

Clerkships

- Judge J. Edward Lumbard, U.S. Court of Appeals for the 2nd Circuit, 1981-1982

Exhibit B

Privileged & Confidential – Prepared at the Request of Counsel



HOULIHAN LOKEY

Chapter 9 Considerations

MERGERS & ACQUISITIONS
CAPITAL MARKETS
FINANCIAL RESTRUCTURING
FINANCIAL ADVISORY SERVICES

HL.com

February 2015

Chapter 9
Considerations

Discriminatory Aspects of Chapter 9

- The comparative lack of creditor protections in Chapter 9 has proven to be uniquely disadvantageous to financial creditors (specifically municipal bond investors) in recent Chapter 9 proceedings
- Pensions in all recent Chapter 9 proceedings have generated significantly higher recoveries on their claims than financial creditors, even in jurisdictions like Detroit, where pension and financial claims were deemed by the bankruptcy court to be pari passu, or of equal standing

City	Recovery	
	Pension	Financial Creditors
Central Falls, RI	■ 75-100% ⁽¹⁾	■ GO: NA ⁽²⁾
Detroit, MI ⁽³⁾	■ 59% - 60%	■ LTGO: 41% ■ COP: 13%
Jefferson County, AL	■ N/A	■ Secured Sewer Bonds: 56%
Stockton, CA	■ 100%	■ Lease Revenue: 1%+ ⁽⁴⁾
Vallejo, CA	■ 100%	■ COP: 53% ⁽⁵⁾

(1) Reflects approximate cut in actual retiree pension distributions

(2) State passed legislation specifically elevating the priority of municipal debt obligations before the city filed for chapter 9 bankruptcy protection

(3) Excludes 74% LTGO recovery due to the bonds' secured status relative to LTGO and COP debt

(4) One creditor received a 1% recovery on their unsecured claim or a 12% recovery on their secured plus unsecured claim

(5) Reflects estimated NPV reduction of Vallejo's costs with respect to approximately \$50 million of COP claims held by Union Bank

Chapter 9 Considerations

Discriminatory Aspects of Chapter 9 (cont.)

- Beyond the objective metrics highlighting vastly divergent pensioner and financial creditor Chapter 9 recovery outcomes, the lack of creditor protections in Chapter 9 has had a negative impact on municipal restructurings in a number of key respects

Restructuring Objective	Outcome
Operational Restructuring Initiatives	<ul style="list-style-type: none"> ■ Despite profound city government dysfunction, no recent Chapter 9 municipal debtors have effected significant operational improvements under Chapter 9 bankruptcy protection ■ According to the court appointed expert in Detroit's bankruptcy, "the majority of the operational restructuring initiatives have been laid in the lap of the mayor and are expected to be executed after the City emerges from bankruptcy" ■ This outcome stands in stark contrast to corporate restructurings, where exigent circumstances are customarily used to effect otherwise challenging institutional changes for the benefit of all stakeholders
Municipal Asset Monetization Strategies	<ul style="list-style-type: none"> ■ Recent Chapter 9 debtors have largely ignored transactional opportunities for City assets as a means of generating capital to catalyze municipal recovery and increase creditor recoveries ■ In unique circumstances such as the partial monetization of Detroit's city-owned art collection, the monetization process was flawed and generated sub-optimal outcomes ■ In the case of Detroit's art collection, the transaction executed in bankruptcy realized a mere \$455 million in value for a city asset appraised at \$8.1 billion
City / Creditor Recovery Alignment	<ul style="list-style-type: none"> ■ In nearly all recent Chapter 9 bankruptcies, financial creditor losses have been set or crystalized with creditors receiving no contingent value recovery mechanisms to allow for incremental creditor recoveries as the city's financial condition improves ■ The "heads I win, tails you lose" outcome stands in stark contrast to the corporate restructuring model which seeks to align creditor and corporate recovery interests ■ The asymmetric risk dynamic acts as a substantial deterrent to new municipal investment capital from either existing or outside creditors as is the norm in the corporate context

Exhibit C

Chart 1

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■ CHICAGO ILL 5 01.01.2040

■ CHICAGO ILL 5 01.01.2040

■ CHICAGO ILL BRD ED 5 12.01....

Chart 1

	Average	First	Last	Max	MaxDate	Min	MinDate	Periods	StdDev	ZScore
■ CHICAGO ILL 5 01.01.2040	130.23	134	168	202	22 Oct 2014	57	02 Mar 2012	817	36.08	1.05
■ CHICAGO ILL 5 01.01.2040	107.86	48	163	197	07 Nov 2014	28	15 Sep 2009	1522	39.95	1.38
■ CHICAGO ILL BRD ED 5 12.01.2042	141.87	98	151	203	24 Oct 2014	86	23 Aug 2012	626	33.01	0.28

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